76-844

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1976

P. L. SNYDER, Petitioner

vs.

R.I.D.C. INDUSTRIAL DEVELOPMENT FUND

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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Robert E. Austin, Jr.
P. O. Drawer 1357
Leesburg, Fl 32748
(904) 787 - 1241
Attorney For Petitioner

Of Counsel:
Timothy A. Burleigh
P. O. Drawer 1357
Leesburg, Fl 32748
(904) 787 - 1241

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The petitioner, P. L. Snyder, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit, entered in this proceeding on September 27, 1976.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 539 F.2d 487 and is reproduced in Appendix A1 to this petition, infra pp. 14 — 27. The opinion of the District Court for the Middle District of Florida is reported at 387 F.Supp. 466 and is reproduced in Appendix A2 to this petition, infra pp. 28 — 43.

JURISDICTION

The judgment of the Court of Appeals was entered on September 27, 1976 (Appendix B1, p. 44 infra). A timely petition for rehearing was denied on November 8, 1976 (Appendix C, p. 48 infra). The jurisdiction of the Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether Section 16 of the Bankruptcy Act, 11 U.S.C. § 34, preserves against a guarantor the right of recovery of a secured creditor that voluntarily submitted itself to the jurisdiction of the bankruptcy court under Chapter XI of the Bankruptcy Act, 11 U.S.C. §§ 701—799, and consented to and joined in a plan of arrangement that provided that any **indebtedness** of the secured creditors consenting to that arrangement remaining unpaid after the last of the distributions provided for therein had been made **"shall be cancelled, discharged and extinguished."**

STATUTORY PROVISION INVOLVED

Section 16 of the Bankruptcy Act, 30 Stat. 550, 11 U.S.C. §34, provides:

> The liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the **discharge of such bankrupt**. (emphasis added)

STATEMENT OF THE CASE

A. **Facts.** In 1964 and 1966, petitioner, P. L. Snyder (Snyder), the defendant and appellee below,

guaranteed two promissory notes executed by Sunnyhill Research and Manufacturing Company (Sunnyhill) [1] to R.I.D.C. Industrial Development Fund (R.I.D.C.), the plaintiff and appellant below. Those notes were entered into pursuant to two credit agreements by virtue of which R.I.D.C. became a secured creditor of Sunnyhill.

In June 1968, Sunnyhill entered into an arrangement proceeding under Chapter XI of the Bankruptcy Act. The plan of arrangement, which was subsequently approved by the bankruptcy court, established schedules for the payment of Sunnyhill's debts and provided in pertinent part as follows:

> 5. Any **indebtedness** of unsecured creditors and the secured creditors executing the attached Consent remaining unpaid after the last of the distributions provided for herein has been made shall be **cancelled, discharged,** and **extinguished.** Debtor shall so notify such creditors.
>
> * * *
>
> CONSENT OF CERTAIN SECURED CREDITORS
>
> In consideration of the above Arrangement and intending to be legally bound hereby, the undersigned hereby consent and agree to the terms of such Arrangement, including but not limited to Section II(5), which provides for the **discharge** of the **debts** of the undersigned . . . . (emphasis added)

1 Although Sunnyhill changed its name to SMAC during the course of the transactions discussed in this petition, for purposes of consistency it will be referred to as Sunnyhill throughout the petition.

R.I.D.C. voluntarily executed a consent to the plan of arrangement. The last of the distributions provided for in the plan of arrangement was made. R.I.D.C., having received less than the full amount of the debt owing to it, brought this diversity action against Snyder as guarantor of Sunnyhill.

B. **Proceedings in the District Court.** The District Court, in proceedings limited to the issue of Snyder's liability under his guaranty, construed the foregoing language and its effect as follows:

> The terms "cancelled" and "extinguished" tend to indicate absolute annihilation of the underlying obligation without any possibility of revival as opposed to the mere "discharge" of the principal debtor which allows for the possibility of restoration or revitalization of the debt under some circumstances and for the continued liability of any sureties.
>
> Therefore, on the basis of the foregoing, this Court concludes that the release of the primary obligor and the extinguishment of the debt under what was a defective plan of arrangement operated to release the defendant guarantor from liability. 387 F.Supp. at 473.

C. **Proceedings in the Court of Appeals.** R.I.D.C. appealed, but never presented as an issue in its briefs the effect given the quoted language of the arrangement by the District Court. Believing that holding of the District Court thus to be beyond the scope of the appeal, Snyder did not argue the correctness of the District Court's position in his brief.

The Court of Appeals for the Fifth Circuit reversed the District Court, remanded for further proceedings consistent with its opinion, and in footnote 3, 539 F.2d at 490, rejected as follows the construction and effect given the plan of arrangement by the District Court:

> Both the district court and the defendant contend that the choice of language in the arrangement that provides: "[a]ny indebtedness . . . remaining unpaid after the last of the distributions provided for herein has been made shall be cancelled, discharged, and extinguished," is of great import to the case. The district court held that the inclusion of "cancelled" and "extinguished" along with "discharged" expressed an intent to "absolute[ly] annihilat[e]" the debt. The defendant argues that discharge of the debt instead of the debtor eliminates the underlying debt, thus preventing the creditor from having recourse to the guarantor. We reject both of these readings. The bankruptcy court can affect only the relationships of debtors and creditor. It has no power to affect the obligations of guarantors. United States v. George A. Fuller Co., F.Supp. 649, 656 (D.Mont. 1966); cf. In re Kornbluth, 65 F.2d 400, 402 (2nd Cir. 1933).

Snyder petitioned for rehearing upon the ground that the construction of the pertinent portion of the plan of arrangement was pivitol to the issue of Snyder's liability, but was not an issue in the briefs of the parties before the Court of Appeals. Snyder's petition for rehearing was denied on November 8, 1976 (Appendix C, p. 48 , infra).

Snyder applied for a stay of mandate upon the decision of September 28, 1976, in order to seek a review of the matter by this Court. On November 24, 1976, the Court of Appeals ordered the mandate stayed to and including December 24, 1976.

REASONS FOR GRANTING THE WRIT

Whether or not Section 16 of the Bankruptcy Act, 11 U.S.C. § 34, can be invoked to protect a secured creditor that, as a volunteer, consented to a plan of arrangement that by its terms cancelled, discharged and extinguished the indebtedness that was guaranteed is an important question of federal law which has not been, but should be, settled by this Court.

Whether or not R.I.D.C.'s release in the plan of arrangement annihilated the underlying obligation is pivotal to a determination of Snyder's liability under his guaranty. If any indebtedness remaining unpaid after the last of the distributions were annihilated by that release, then no unpaid portion of the guaranteed debts would exist after the completion of the arrangement and Snyder would not be liable to R.I.D.C.

The Court of Appeals and the District Court generally reached the same result. The critical difference between the two decisions is the position of the Court of Appeals concerning the effect of R.I.D.C.'s consent to and joinder in the plan of arrangement. Although the Court of Appeals discarded much of the reasoning of the District Court's opinion, the conclusion is the same: Snyder is obligated to pay any indebtedness that remains undischarged by the

arrangement proceedings and the contractual arrangement between R.I.D.C. and Snyder's primary obligor. Both courts below found that the bankruptcy court does not have jurisdiction of its own to annihilate a debt, as to a guarantor thereof. The difference between the two opinions is that the District Court gave effect to R.I.D.C.'s voluntary contractual act consenting to the cancellation, discharge and extinguishment of the debt, while the Court of Appeals refused to do so.

R.I.D.C.'s consent to and joinder in the arrangement was a voluntary act not required of it. Since a bankruptcy court does not have jurisdiction to alter the liability of a guarantor, the relationship between R.I.D.C. and Snyder's primary obligor was a voluntary contractual relationship closely analagous to the relationship flowing from a common law composition of creditors, which has the effect of releasing the debtor's guarantors. R.I.D.C., as a secured creditor, finds itself as a volunteer in the bankruptcy proceedings except as to the bankruptcy court's limited jurisdiction over secured creditors. As a volunteer, R.I.D.C. limited itself to whatever it could recover in the arrangement prceedings and voluntarily released the guarantors of the obligation by agreeing that after the last of the distributions provided for in the plan of arrangement, any indebtedness remaining unpaid would be cancelled, discharged and extinguished. As a result of that voluntary agreement of R.I.D.C., when the last of distributions under the arrangement was made, no debt remained. Snyder therefore has no liability to R.I.D.C.

The language of the plan of arrangement to which

R.I.D.C. consented is clear. The plan of arrangement does not speak in terms of discharging the debtor or the bankrupt. Rather, the plan of arrangement provides that any **indebtedness** of the secured creditors executing the consent remaining unpaid after the last of the distributions provided for in that plan of arrangement has been made "shall be **cancelled, discharged** and **extinguished.**"

A "discharge in bankruptcy" is analogous to a statute of limitations in that it does not annul the original debt but merely suspends the right of action for its recovery. Local Loan Co. v. Norman, 319 Ill.App. 114, 48 N.E.2d 803 (1st Dist.App.Ct. 1943) (abstract opinion). It "is not a payment or extinguishment of the debt; it is simply a bar to all future legal proceedings for enforcement of the discharged debt." New England Merchants National Bank v. Herron, 243 A.2d 722, 725 (Me. 1968), quoting Collier on Bankruptcy, para. 17.29, at 1735 (14th ed. 1941).

"Cancellation" and "extinguishment" differ from "discharge". The distinction is illustrated by the following quotations:

> Cancellation of a negotiable instrument is a manifestation by act of intention with reference thereto to render same inefficacious as a legal obligation. . . . It is not necessary that a cancellation be supported by a consideration. Hickox v. Hickox, 151 S.W.2d 913, 917, 918 (Tex.Ct.Civ.App. 1941).
>
> To cancel is to nullify, declare null and void; to set at naught the provisions of the instrument

> canceled and to declare them null and void. Friedman v. City of Chicago, 374 Ill. 545, 30 N.E.2d 36, 39 (1940).

A party who holds a contract of guaranty may by his act release the guarantor, even though he may not intend to do so. A guarantor is discharged by operation of law from further liability by an act which extinguishes the principal obligation. 38 C.J.S. Guaranty § 69 (1943). See Rabon v. Putnam, 164 F.2d 80 (10th Cir. 1947) and American Surety Co. v. Morton, 200 F.Supp. 82 (E.D. Ill. 1961), aff'd 311 F.2d 222 (7th Cir. 1962).

Similarly, it may be stated generally that a person secondarily liable for a debt is discharged by a composition with a person primarily liable therefor, unless there is an express reservation of right against persons secondarily liable. 15A C.J.S. Compositions with Creditors § 11 (1967).

With some exceptions, as where the guarantee's right of recourse against the guarantor is reserved, acts of the guarantee which have the effect of discharging the principal debtor despite the lack of complete payment or of complete performance of the guaranteed contract also operate as a discharge of the guarantor. There has been no reservation of rights against Snyder. Where the principal debtor has not made complete payment or has not completely performed the guaranteed contract, but the effect of the creditor's acts is nevertheless to release or discharge him, the guarantor is also discharged, unless the guarantee's right of recourse against the guarantor is expressly reserved in the contract releasing

the principal. Thus, where the creditor enters into a compromise agreement with the debtor, the effect of which is to release the debtor from further liability, the guarantor can no longer be held liable unless the guaranty contracts provide otherwise. 38 C.J.S. Guaranty § 83 (1943). See Williams v. DeSoto Bank & Trust Co., 192 La. 848, 189 So. 451 (1939).

In a Chapter XI proceeding, the bankruptcy court has jurisdiction, inter alia, to discharge the debts of unsecured creditors. However, the power of the bankruptcy court in a Chapter XI proceeding is limited as to secured creditors. As stated in the opinion of the Court of Appeals herein, at 539 F.2d at 493, the bankruptcy court "can 'deal with the rights of secured creditors' in a Chapter XI arrangement **to the extent that those secured creditors voluntarily agree to the arrangement.**" (emphasis added)

Since the bankruptcy court in this case was without jurisdiction to affect the debts of R.I.D.C., a secured creditor, except to the extent that it agreed to the arrangement, the extinguishment of R.I.D.C.'s debt occurred not by operation of law, but by operation of contract by R.I.D.C.'s voluntary consent to and joinder in the plan of arrangement. That plan of arrangement went beyond the discharge of the bankrupt; it provided for the cancellation and extinguishment of the debt itself. As such, it was equivalent to a common law composition of creditors.

R.I.D.C.'s debt is thus beyond the protection of Section 16 of the Bankruptcy Act, 11 U.S.C. § 34. That section protects claims against guarantors from **discharge of the bankrupt,** which is discharge by

operation of law, and not discharge by operation of contract.

In this case, it was not the bankruptcy court's order, per se, that extinguished the debt. Rather, it was R.I.D.C.'s voluntary consent to and joinder in the plan of arrangement. That R.I.D.C.'s consent to the extinguishment of the debt was contained in the plan of arrangement should not affect the validity of that consent. The bankruptcy court did not and could not release Snyder; R.I.D.C. could, and by joining in the plan of arrangement, did release Snyder. Had R.I.D.C. not joined in the plan of arrangement, then Snyder concedes that the language of that plan would not be a valid defense, but since R.I.D.C. did consent, without reserving any right against Snyder, Snyder was released as a guarantor.

The rejection by the Court of Appeals of the District Court's holding that R.I.D.C.'s joinder in the arrangement annihilated the debt extends the operation of Section 34 of the Bankruptcy Act.

Whether that extension is proper is an important question of federal law that should be settled by this court.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

Robert E. Austin, Jr.
P. O. Drawer 1357
Leesburg, FL 32748
(904) 787-1241
ATTORNEY FOR PETITIONER

CERTIFICATE OF SERVICE

I CERTIFY that three copies of the foregoing were furnished to each of the following, who are all of the parties required to be served, in compliance with Rule 33.1 of this Court, by air mail, the 19th day of December, 1976:

Frank D. Newman, Esq.
Post Office Box 1870
Deland, FL 32720

Paul A. Manion, Esq.
Messrs. Read, Smith, Shaw & McClay
747 Union Trust Building
Pittsburg, PA 15230

Robert L. Potter, Esq.
3900 Forbes Avenue
Pittsburg, PA 15260

Robert E. Austin, Jr.

APPENDIX A1

R.I.D.C. INDUSTRIAL DEVELOPMENT FUND, Plaintiff-Appellant,

v.

P. L. SNYDER, Defendant-Appellee.

No. 75—1570.

United States Court of Appeals,
Fifth Circuit.

Sept. 27, 1976.

Appeal from the United States District Court for the Middle District of Florida.

Before WISDOM and MORGAN, Circuit Judges, and LYNNE, District Judge.

MORGAN, Circuit Judge.

In 1964 and 1966, defendant P. L. Snyder guaranteed two promissory notes executed by Sunnyhill Research and Manufacturing Company (Sunnyhill)[1] to plaintiff R.I.D.C. Industrial Development Fund (R.I.D.C.). Finding itself unable to pay its debts when they came due, Sunnyhill entered into an arrangement proceeding under Chapter XI of the Bankruptcy Act, 11 U.S.C. §§ 701—799. R.I.D.C., having received less than the full face amount of the debt owing to it, brought this diversity action against defendant Snyder as guarantor of Sunnyhill. The district court, 387 F.Supp. 466 held that R.I.D.C.'s participation in the Chapter XI proceedings released defendant Snyder from further obligation under the guarantee. R.I.D.C. appeals.

1 Although Sunnyhill changed its name to SMAC during the course of the transactions discussed in this opinion, for purposes of consistency we will refer to it as Sunnyhill throughout the opinion.

I.

In August of 1964, R.I.D.C. and Sunnyhill entered into a credit agreement under which R.I.D.C. lent Sunnyhill $335,000. The loan was conditioned upon Sunnyhill granting R.I.D.C. a security interest in all presently owned and after-acquired equipment, and upon defendant Snyder and his brother, the principals of Sunnyhill, guaranteeing the payment of all indebtedness under the credit agreement.

Two years later in April of 1966, R.I.D.C. and Sunnyhill entered into a second credit agreement under which R.I.D.C. lent Sunnyhill an additional $100,000. In connection with this loan, Sunnyhill granted another security interest which covered all present and after-acquired inventory and which also included a cross-collateral provision tying this security interest to the existing security interest in equipment. Once again, defendant Snyder and his brother were required to execute personal guarantees.

Five months later, in September 1966, Sunnyhill found itself unable to pay its debts as they matured. The creditors, including R.I.D.C., agreed to a six-month moratorium on collections. The Snyder

brothers, as guarantors of payment under the 1964 and 1966 credit agreements, consented to the extension.

Sunnyhill's financial condition did not improve, so it sought and eventually found a purchaser for its assets. On January 22, 1968, SRM Company (SRM) and Sunnyhill entered into an acquisition agreement under which SRM purchased all of Sunnyhill's assets with the exception of its inventory which SRM agreed to buy as the need arose. Concurrently, SRM and R.I.D.C. agreed that R.I.D.C.'s security interest would continue in the equipment formerly belonging to Sunnyhill until SRM paid the entire sum due Sunnyhill. The following day, R.I.D.C. and certain other creditors of Sunnyhill entered into an agreement regarding payment of Sunnyhill's debts.[2] The Snyder brothers, as guarantors, consented to all of these transactions. In June of 1968, under pressure from creditors other than R.I.D.C., Sunnyhill entered into an arrangement proceeding under Chapter XI of the Bankruptcy Act. Under this arrangement, the creditors set up payment schedules quite similar to those under the Creditor's Agreement of January 23, 1968, but also provided that "any indebtedness . . . remaining unpaid after the last of the distributions . . . shall be cancelled, discharged and extinguished."[3] It further provided that the Chapter XI arrangement superseded the Creditors' Agreement of January 23, 1968, and that the secured creditors "agree that during the term of the Arrangement they will not take any action to enforce their rights as secured creditors of the debtor." The Snyder brothers did not execute a written consent as guarantors of debts affected by the arrangement.

The district court held that R.I.D.C. was a secured creditor by virtue of continuation of its security agreement in the equipment sold to SRM, that as secured creditors they were outside of the jurisdiction of Chapter XI of the Bankruptcy Act, that because there was no jurisdiction the arrangement was merely a contractual agreement among the parties, and that accordingly their rights against the guarantors were not protected by § 16 of the Bankruptcy Act, 11 U.S.C. § 34, because the remainder of the debt was not discharged under the coercive powers of the Bankruptcy Court. R.I.D.C. appeals, arguing that it was not

2 Section 3(e) of the Creditor's Agreement of January 23, 1968, provides that R.I.D.C. would receive 335/435 of the payments from sale of the assets of Sunnyhill to SRM and that Sun Capital would receive 100/435. Both were secured with regard to different classes of the assets which were sold as a whole to SRM. Section 3(f) provided that R.I.D.C. would receive the first $100,000 received from the sale of inventory and 435/535 of any proceeds in excess of $100,000. Thus, while it is unclear from the record whether the Creditor's Agreement set up preferences for R.I.D.C. identical in effect to its security interests, it is clear that the agreement did set up preferences quite similar to its security interests.

3 Both the district court and the defendant contend that the choice of language in the arrangement that provides: "[a]ny indebtedness . . . remaining unpaid after the last of the distributions provided for herein has been made shall be cancelled, discharged, and extinguished," is of great import to the case. The district court held that the inclusion of "cancelled" and "extinguished" along with "discharged" expressed an intent to "absolute[ly] annihilat[e]" the debt. The defendant argues that discharge of the debt instead of the debtor eliminates the underlying debt, thus preventing the creditor from having recourse to the guarantor. We reject both of these readings. The bankruptcy court can affect only the relationships of debtors and creditor. It has no power to affect the obligations of guarantors. United States v. George A. Fuller Co., 250 F.Supp. 649, 656 (D.Mont.1966); cf. In re Kornbluth, 65 F.2d 400, 402 (2nd Cir. 1933).

a secured creditor, and even if it were secured, it was nevertheless protected by § 16.

II.

One of the primary purposes for obtaining a guarantor to a note is to provide an alternative source of repayment in the event that the principal obligor's debt is discharged in bankruptcy.[4] Accordingly, the Bankruptcy Act provides that discharge in bankruptcy will not alter the liability of a guarantor. Section 16 of the Act states:

> The liability of a person who is a codebtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of such bankrupt.[5]

The district court held this section inapposite because the Bankruptcy Court lacked jurisdiction to discharge secured debts. The plaintiff attacks that ruling, arguing alternatively that he was not a secured creditor, and that even if he were, his participation in the Chapter XI proceedings is protected by § 16.

The conclusion of the district court that R.I.D.C. was a secured creditor is based on the security interest that R.I.D.C. held in the equipment in the hands of SRM. In support of this proposition, the district court cites §9—105 of the Uniform Commercial

4 See Maryland Casualty Co. v. Moore, 82 F.2d 189 (2nd Cir.), cert. denied, 298 U.S. 666, 56 S.Ct. 749, 80 L.Ed. 1390 (1936).

5 11 U.S.C. § 34. See United States v. Anderson, 366 F.2d 569, 571 (10th Cir. 1966).

Code and Official Comment 2 to that section. We find, however, that the district court's reliance on the Uniform Commercial Code is misplaced.

To determine who is a secured creditor for purposes of the Bankruptcy Act, one must turn not to the Uniform Commercial Code, but to the definitions within the Act.[6] 11 U.S.C. §1(28) provides:

> "Secured creditor" shall include a creditor who has security for his debt upon the property of the bankrupt of a nature to be assignable under this title or who owns such a debt for which some endorser, surety, or other person secondarily liable for the bankrupt has such security upon the bankrupt's assets.

This definition is narrower than the popular meaning of the term "secured creditor" and clearly excludes cases in which the security interest is in property not belonging to the bankrupt,[7] even if the security interest originally encumbered property of the bankrupt that the bankrupt parted with prior to bankruptcy. In Ivanhoe Building and Loan Association v. Orr, 295 U.S. 243, 55 S.Ct. 685, 79 L.Ed. 1419

6 The definitions in § 1 of the Act are made applicable to Chapter XI proceedings by virtue of 11 U.S.C. § 702.

7 In re United Cigar Stores Co. of Am., 73 F.2d 296, 297, 298 (2d Cir. 1934), cert. denied, 294 U.S. 708, 55 S.Ct. 405, 79 L.Ed. 1243 (1935). See 1 Collier on Bankruptcy, ¶ 1.28 at 130.24 (14th ed. 1976); 9 Collier on Bankruptcy, ¶ 8.01 at 169 (14th Ed. 1976); 3 Collier on Bankruptcy, ¶ 57.07 at 164 (14th ed. 1976). Murphy, Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings, 30 Bus.Law 15, 17 n. 11 (1974).

(1935), the bankrupt's trustee attempted to have the plaintiff classified as a secured creditor because it continued to hold a security interest in some property which the bankrupt had previously held while the property was under the plaintiff's security interest. The court ruled that the decision must be governed by the definition in § 1 of the Act and that the plaintiff did not come within the definition because it held no security against the bankrupt's property at the date of bankruptcy.[8]

The circumstances in the present case are nearly identical to those in Ivanhoe. R.I.D.C., like the claimant in Ivanhoe, held a security interest in property in the possession of the bankrupt, but prior to bankruptcy the property was conveyed to a third person.[9] Thus, with respect to the 1964 security interest in equipment, R.I.D.C. was not a secured creditor.[10]

Although we must reverse the district court's ruling that R.I.D.C. was a secured creditor by virtue of its security interest on equipment sold to SRM, the

8 295 U.S. at 245—46, 55 S.Ct. 685. See 1 Collier on Bankruptcy, ¶ 1.28 at 130.25 (14th ed. 1976).

9 Compare In re United Cigar Stores, 73 F.2d 296, 297—98 (2nd Cir. 1934), in which the court refused to pierce the corporate veil and held that the creditor was unsecured even though the bankrupt held all of the stock of corporation owning the collateral.

10 Appellee contends that R.I.D.C. held a security interest in the proceeds from the sale of collateral to SRM. The security agreement, however, failed to include the word "proceeds" in the description of the collateral and thus no security interest is created. 12A Pa.Stat.Ann. § 9—203. R.I.D.C.'s rights in the proceeds were limited to those agreed to in the SRM acquisition agreement and the creditor's agreement.

1966 security interest on the inventory operates to render R.I.D.C. a secured creditor because part of the inventory remained in the possession of Sunnyhill after the sale of its other assets to SRM.[11] Moreover, R.I.D.C. conceded at argument that the 1964 and 1966 loans were cross-collateralized. Consequently, R.I.D.C. was a secured creditor with regard to all of the debts owed it by Sunnyhill.

III.

Once the district court determined that R.I.D.C. was a secured creditor, the court went on to consider whether it could avail itself of the protection of § 16 of the Bankruptcy Act. The court reasoned that since R.I.D.C. was a secured creditor, the debt owed it by Sunnyhill could not be discharged in a Chapter XI proceeding. Accordingly, the discharge of Sunnyhill's debt was not a coercive effect of the Bankruptcy Act, but a contractual agreement voluntarily entered into by R.I.D.C. Since the discharge was not accomplished under the Bankruptcy Act, § 16 could not protect R.I.D.C. from the effect of its "voluntary discharge of Sunnyhill" upon the guarantee agreement with Snyder. Our examination of the problem leads us to a contrary conclusion: bankruptcy courts may have jurisdiction over secured creditors in Chapter XI proceedings and, if the debt owed the secured creditor is altered by a Chapter XI arrangement, the secured creditor's guarantee is insulated by § 16 of the Bankruptcy Act.

In both SEC v. American Trailer Rentals, 379 U.S.

11 See appellant's brief at 25 n. 35.

594, 605, 85 S.Ct. 513, 13 L.Ed.2d 510 (1965), and SEC v. U.S. Realty and Improvement Co., 310 U.S. 434, 446, 60 S.Ct. 1044, 84 L.Ed. 1293 (1940), the Supreme Court stated that the purpose of Chapter XI proceedings is to secure judicial confirmation to an arrangement, or adjustment, of a debtor's unsecured obligations.[12] In the recent case of In re Texas Consumer Finance Corp., 480 F.2d 1261 (5th Cir. 1973), this court discussed the meaning of those cases and the complementary roles of Chapter X and Chapter XI. In that case the bankruptcy court had attempted to impoe upon certain parties a requirement that they surrender their shares of preferred stock as a condition to the confirmation of the proposed Chapter XI arrangement. We said at that time, "no provision of the Act permits an arrangement proposed under Chapter XI to deal with the rights of secured creditors or with the rights of stockholders." We now limit that dicta in two regards. First, we recognize the obvious proposition that Chapter XI arrangements can deal with the rights of secured creditors or stockholders to the extent that it deals with those individuals' concurrent role as unsecured creditors. Second, we must conclude, that the Bankruptcy Court has jurisdiction to impose certain restrictions on secured creditors during the period prior to confirmation, and can "deal with the rights of secured creditors" in a Chapter XI arrangement to the extent that those secured creditors voluntarily agree to the arrangement.

12 See, also, General Stores Corp. v. Shlensky, 350 U.S. 462, 76 S.Ct. 516, 100 L.Ed. 550 (1956).

When a creditor is owed two debts, one of which is secured and the other is not, it cannot be seriously argued that the unsecured debt is excluded from participation in an arrangement because the creditor holds another debt which is secured. That case, however, is logically indistinguishable from the case of a secured creditor whose secured debt is secured by collateral less valuable than the full amount of the debt. When the value of the security is less than the full amount of the debt, the

> "secured" creditor is the holder of an unsecured debt for such sum as may be owing over and above the value of the security. The plan may deal with that unsecured debt, whether the plan is by way of settlement, satisfaction, or extension.

9 Collier on Bankruptcy ¶ 8.01 at 169 (14th ed. 1976). Thus, in United States v. National Furniture Co., 348 F.2d 390 (8th Cir. 1965), the Small Business Administration was allowed to participate in a Chapter XI arrangement to the extent that the debt owed it exceeded the value of its collateral.[13] Accordingly, we must conclude that R.I.D.C. was entitled to participate in the arrangement as an unsecured creditor to the extent that the debt owed it by Sunnyhill exceeded the value of the inventory.

Participation of R.I.D.C. in the arrangement was not, however, limited to the extent that the debt owed

13 348 F.2d at 392, 9 Collier ¶ 8.01 at 169. See In re Everick Art Corp., 39 F.2d 765, 768 (2nd Cir. 1930). Law Research Service, Inc. v. Crook, 524 F.2d 301, 311 (2nd Cir. 1975).

it exceeded the value of the collateral. It is apparent from the terms of the arrangement that it reached the entirety of Sunnyhill's estate and eliminated the security interest of R.I.D.C. While it is clear that a bankruptcy court lacks jurisdiction under Chapter XI to **compel** a secured creditor to participate in an arrangement that alters his security interest, the present case raises the question of whether the court has jurisdiction to **allow** him to participate without sacrificing other legal rights.

As we pointed out in In re Texas Consumer Finance Corp., 480 F.2d 1261 (5th Cir. 1973), the purpose of Chapter XI is to "insure continuation of the business under a self-determined arrangement."[14] The underlying theory is that the going concern value of the business is greater than its value if liquidated. In many cases foreclosure of security interests would hamper the ability of a business to continue to such an extent that it could no longer carry on normal business operations. In such a situation, it is in the interest of the unsecured creditors to work out an arrangement under which secured creditors receive compensation equal in value to their security interests in exchange for voluntarily participating in the plan.

In Armstrong v. Alliance Trust Company, 112 F.2d 114 (5th Cir. 1940), the debtor sought relief by composition of his debts under § 74 of the Bankruptcy Act of March 3, 1933, the predecessor provision to Chapter XI. Section 74 provided that "such extension

14 480 F.2d at 1266. See S. E. C. v. United States Realty Improvement Co., 310 U.S. 434, 446, 451, 60 S.Ct. 1044, 84 L.Ed. 1293 (1940).

or composition shall not reduce the amount of or impair the lien of any secured creditor, but shall affect only the time and method of its liquidation." We ruled that a secured creditor could not be compelled to reduce a secured debt, but "if the particular creditor so affected consents, the proposal can of course be confirmed."[15] The facts in the present case are quite similar. R.I.D.C. was not compelled to sacrifice its security interests; it voluntarily did so, apparently in an attempt to maximize the value of Sunnyhill's estate and thus increase the amount of the debt that would be repaid.

In addition to serving the purpose of maximizing the value of the debtor's estate, allowing the secured creditors to voluntarily participate in an arrangement may protect the secured creditor from loss of value resulting from the lengthier proceedings that would be necessary if the bankruptcy court must pass upon the validity and the value of the security interest.[16] Section 314 of the Bankruptcy Act gives the bankruptcy court the power to restrain secured creditors. "The court may, . . . upon notice and for cause show, enjoin or stay until final decree any act or the commencement or continuation of any proceeding to enforce any lien upon the property of a debtor."[17] This provision may be invoked if the validity of a lien

15 112 F.2d at 117. See Yacos, Secured Creditors and Chapter XI of the Bankruptcy Act, 44 J. of Natl. Conf. of Referees in Bankruptcy 29 (1970) (hereinafter cited as Yacos).

16 See, generally, Law Research Service, Inc. v. Crook, 524 F.2d 301 (2nd Cir. 1975).

17 See Yacos at 29—30.

or the extent of the property covered is challenged. Allowing a secured creditor to voluntarily join in an arrangement may facilitate completion of the Chapter XI process by allowing compromise among the interested parties on these issues. [18]

We hold that, as in straight bankruptcy, the secured creditor has the option in a Chapter XI proceeding to prove its claim as a secured creditor and be given credit for the value of the security as well as a claim for the unsecured balance. [19] To limit the secured creditor to foreclosure followed by filing of a claim for the unsecured balance or surrender of the security followed by filing for the whole claim as an unsecured creditor would undermine the Chapter XI purpose of maintaining a viable business, when feasible, to benefit all creditors and the debtor. [20] If the business is worth more as a going concern than it would bring in liquidation, then it is also to the guarantor's advantage to allow this option since more of the debt will be paid by the debtor. [21]

18 There is no reason to assume that a secured creditor would agree to an arrangement that would not maximize the total amount, secured and unsecured, that he would receive from the debtor. His interest is consistent with that of the guarantor; the more he collects from the debtor, the less he needs to collect from the guarantor.

19 See In re Pennyrich Int'l, Inc., 473 F.2d 417, 422 (5th Cir. 1973); 3 Collier at ¶ 57.07[3] at 169; cf. United States Natl. Bk. v. Chase Natl. Bk., 331 U.S. 28, 33—34, 67 S.Ct. 1041, 91 L.Ed. 1320 (1947).

20 Compare New York Terminal Warehouse Co. v. Bullington, 213 F.2d 340, 344 (5th Cir. 1954).

21 See, also, Continental Illinois National Bk. & Trust Co. v. Chicago, Rock Island & Pacific Ry., 294 U. S. 648, 675—81, 55 S.Ct. 595, 79 L.Ed. 1110 (1935) (discussion of similar concerns under the Railroad Reorganization Act).

We conclude that the bankruptcy court did have the jurisdiction to confirm an arrangement voluntarily entered into by R.I.D.C. which altered R.I.D.C.'s status as a secured creditor. The arrangement does not affect the responsibility of Sunnyhill's guarantors to make good on the unpaid portion of the guaranteed debts that remain after the arrangement has been completed. [22]

Accordingly, we REVERSE and REMAND for further proceedings consistent with this opinion.

22 Since we conclude that the bankruptcy court had jurisdiction, it is unnecessary for us to reach the question of whether the creditor violated the guarantee agreement by joining a contractual composition.

APPENDIX A2

R.I.D.C. INDUSTRIAL DEVELOPMENT FUND, Plaintiff,

v.

P. L. SNYDER, Defendant.

No. 72—45—Civ—Oc.

United States District Court,
M. D. Florida,
Ocala Division.

Jan. 9, 1975.

ORDER AND OPINION

CHARLES R. SCOTT, District Judge.

This is a suit based on certain promissory notes executed by the primary obligor, Sunnyhill Research & Manufacturing Company (hereinafter referred to as SMAC or Sunnyhill, its successor in interest and now a bankrupt), in favor of the plaintiff and guaranteed by the defendant P. L. Snyder, a principal in SMAC. Involved in this case is the question of the effect of a plan of arrangement under Chapter XI of the Bankruptcy Act on a secured creditor which attempted to voluntarily submit itself to the jurisdiction of the bankruptcy court. This Court concludes that the plaintiff is barred as a matter of law from proceeding against the defendant on the notes in question.

I. FACTUAL BACKGROUND

Plaintiff R.I.D.C. Industrial Development Fund and SMAC's predecessor in interest, Sunnyhill Research & Manufacturing Company, entered into two credit agreements, one dated August 24, 1964, and the other dated April 11, 1966, pursuant to which the two subject promissory notes of $335,000.00 and $100,000.00, respectively, were executed by Sunnyhill in favor of the plaintiff. These credit agreements provided:

> 4. To induce the lenders to enter into this agreement and as a condition precedent to its rights to borrow hereunder, Company has:
>
> (a) executed and delivered a chattel mortgage to R.I.D.C. Fund covering all its present equipment with an after acquired property clause to cover any equipment which it may acquire in the future and constituting, or to constitute, as the case may be, a first lien thereon for the purpose of securing the R.I.D.C. Fund loan;

By virtue thereof, plaintiff became a secured creditor of SMAC. In addition, the defendant P. L. Snyder, along with his now deceased brother C. H. Snyder, in accordance with the provisions of the credit agreements, executed two guaranty agreements, dated, respectively, August 24, 1964, and November 9, 1966. These guaranty agreements provided in pertinent part as follows:

Guarantors, their heirs and assigns, jointly and severally, do hereby absolutely and unconditionally promise and guarantee to R.I.D.C. Fund the prompt and punctual payment of all amounts required to be paid under said Credit Agreement; and that the obligations assumed and guaranteed by Guarantors shall continue with the same force and effect until the debt is paid in full; and further that recourse may be made to Guarantors upon this Guaranty without requiring any proceedings to be taken against Borrower, and that any change or alteration in the Credit Agreement shall not discharge the obligation of Guarantors hereunder, which shall be absolute until all claims of R.I.D.C. Fund against Borrower arising out of said Credit Agreement shall have been settled and discharged in full; however **Guarantors shall not be bound hereunder by any alteration or modification of said Credit Agreement which extends the term of repayment or increases the amount due thereunder without their written approval of any such alteration or modification.** (emphasis added)

On January 22, 1968, with the defendant's written consent, SRM Company entered into an acquisition agreement with Sunnyhill, the principal obligor, and purchased all of its assets. That agreement listed R.I.D.C. as a secured creditor under its schedule of "Permitted Liens." On the same date, SRM Company and Sunnyhill, also with the defendant's consent, entered into a modification of security agreement whereby the parties thereto agreed that R.I.D.C.'s security interest would continue in the machinery,

equipment and tools but not as to the inventory. Sunnyhill and SRM Company also agreed that SRM Company would not assume the obligations underlying the security interest.

On January 23, 1968, plaintiff R.I.D.C. Fund and certain other creditors of Sunnyhill, with the defendant's written consent, entered into an agreement regarding payment of amounts due both secured and unsecured creditors. Plaintiff requested and secured the written consent of the defendant for its entry into the acquisition agreement, the modification of security agreement and the creditors agreement because the terms thereof were such as to materially modify the guaranty agreements and thus the guarantors' consent was necessary to prevent their release from any obligation thereunder. 74 Am.Jur.2d, Suretyship, §§ 50—51. This Creditors' Agreement provided in paragraphs 7 and 8 as follows:

7. This agreement shall terminate upon the happening of any of the following events:

(a) the payment in full of all creditors of Sunnyhill disclosed on Exhibit "A";

(b) the unanimous agreement of the parties hereto; or

(c) **the valid and effective foreclosure by R.I.D.C. Fund of its security interest** (or acquisition of title of the assets pursuant to said security interest) with respect to assets or inventory covered by Section 2.01 and/or Articles V and VII of the SRM Agreement.

(emphasis added)

> 8. **In the event of bankruptcy** or other cessation of business of SRM, all funds held by Sunnyhill for distribution to creditors shall be promptly distributed and thereafter **this agreement shall terminate.** (emphasis added)

In June 1968 Sunnyhill entered into an arrangement proceeding under Chapter XI of the Bankruptcy Act, 11 U.S.C. §§ 701—799. The record does not indicate that plaintiff R.I.D.C. ever sought the defendant's written approval of R.I.D.C.'s participation in the plan of arrangement. In addition, the record is clear that the defendant never actually agreed or consented in writing to plaintiff's participation in the Chapter XI proceeding. The plan of arrangement, which was subsequently approved by the bankruptcy court on July 2, 1968, provided in pertinent part as follows:

> 5. Any **indebtedness** of unsecured creditors and the **secured creditors** executing the attached Consent remaining unpaid after the last of the distributions provided for herein has been made shall be **cancelled, discharged and extinguished.** Debtor shall so notify such creditors. (emphasis added)
>
> 6. This Arrangement upon confirmation **shall supersede the provisions of the Agreement dated January 23, 1968** between the debtor, Sun Capital, R.I.D.C. and the Creditors' Committee established pursuant to a Creditors' Agreement dated January 6, 1967.

. . . . . .

Consent of Certain Secured Creditors

> In consideration of the above Arrangement and intending to be legally bound hereby, the undersigned hereby consent and agree to the terms of such Arrangement, including but not limited to Section II(5), which provides for the discharge of the debts of the undersigned, and the undersigned **agree that during the term of the Arrangement they will not take any action to enforce their rights as secured creditors of the debtor.** If such Arrangement is not confirmed, this Consent shall be cancelled, but the undersigned may not withdraw this Consent before the Court renders a decision regarding confirmation and, if the plan is confirmed, this Consent shall thereafter be irrevocable. (emphasis added)

This consent was signed by D. R. Clifford, as executive vice-president of R.I.D.C., and C. H. Snyder, as president of Sun Capital Corporation. The net effect of the arrangement was: (1) to assign priorities to R.I.D.C. and Sun Capital, the secured creditors, and the unsecured creditors as to any sums that would be available for distribution, and (2) to extend the time of payment of the bankrupt's debts.

The plaintiff, after rendering itself unable to collect the full amount of the debt from the principal obligor, Sunnyhill, brought this action against one of the guarantors, P. L. Snyder, for $312,869.03 on the 1964 note and for the full $100,000.00 on the 1966 note, for a total of $412,869.03.

The defendant contends, under the established principles of suretyship law, that the Plan of Arrangement, which provided that "any indebtedness of . . . the secured creditors [was] . . . cancelled, discharged and extinguished" as to the principal obligor also extinguished any liability on his part as a guarantor or surety since he did not consent to it. 74 Am.Jur.2d, Suretyship, § 98. See Dabney v. Chase National Bank of City of New York, 201 F.2d 635, 641 (2d Cir. 1953), cert. den. 346 U.S. 863, 74 S.Ct. 102, 98 L.Ed. 374; Sarasota County, Florida v. American Surety Co. of New York, 68 F.2d 543, 544 (5th Cir. 1934). Restatement of Security § 122.

The plaintiff, on the other hand, contends that Section 16 of the Bankruptcy Act, 11 U.S.C. § 34, nevertheless preserves the right of recovery against a guarantor. That section provides as follows:

> The liability of a person who is a codebtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of such bankrupt.

Both parties agree that this section is applicable to Chapter XI proceedings. United States v. George A. Fuller Co., 250 F.Supp. 649 (D.Mont. 1966); 1 Collier, Bankruptcy, § 16.02 at 1525 (14th ed. 1964). The bankruptcy court is simply without the power to affect the underlying obligation as to the surety. United States v. George A. Fuller Co., supra, at 658.

The defendant counters with the argument that the plan of arrangement could not affect the legal rights of the plaintiff by operation of law under the Bankruptcy

Act since the plaintiff participated therein as a secured creditor. Therefore, the defendant argues, the plan of arrangement, which is thus a nullity under the bankruptcy law, becomes a contractual agreement between the creditor and the principal obligor so that the well-settled general principles of suretyship law apply so as to extinguish the liability of the defendant surety.

The defendant is certainly correct that if the plaintiff **did in fact** participate in the plan of arrangement as a secured creditor without relinquishing its security, then the plan of arrangement could not affect the legal rights of the plaintiff in the manner provided for under the Bankruptcy Act. In the Fifth Circuit decision of In re Texas Consumer Finance Corporation, 480 F.2d 1261 (5th Cir. 1973), the Court stated:

> **No provision of the Act permits an arrangement proposed under Chapter XI to deal with the rights of secured creditors** or with the rights of stockholders. See 9 Collier in Bankruptcy, § 8.01 at 155 (14th ed. 1940). . . . Thus, a Chapter X reorganization plan may affect the securities of the debtor corporation, **but only the rights of the debtor's unsecured creditors may be arranged under Chapter XI.** The status of the debtor's securities may not be altered. . . . (citing cases) (emphasis added).

480 F.2d at 1265. The question then arises as to whether the plaintiff was a secured creditor at the time it participated in the Chapter XI proceedings.

II. WAS R.I.D.C. A SECURED CREDITOR WHEN IT CONSENTED TO THE PLAN OF ARRANGEMENT?

The evidence seems clear that R.I.D.C. was a secured creditor of Sunnyhill when SRM purchased the assets of Sunnyhill on January 22, 1968. Section 3.06(a) of the acquisition agreement between SRM Company and Sunnyhill provided, in pertinent part, as follows:

> None of the Assets to be Acquired is subject to any mortgage, pledge, lien, conditional sale agreement, security title, encumbrance or other charge **except Permitted Liens.** (emphasis added)

The Schedule of Permitted Liens affixed to the agreement listed the following lien:

> 1. Security Agreement between R.I.D.C. Industrial Development Corporation and Sunnyhill Research & Manufacturing Company dated August 28, 1964.

The modification of security agreement, also dated January 22, 1968, implicitly suggests that the 1966 credit agreement was but an extension of the 1964 credit agreement so that the security for both loans survived the acquisition agreement between SRM and Sunnyhill.

In addition, as indicated previously, the Creditors' Agreement dated January 23, 1968, one day after the date of the acquisition agreement, provided that the agreement, would terminate upon the happening of

"the valid and effective foreclosure by R.I.D.C. Fund of its security interest." Furthermore, Exhibit A of the Creditors' Agreement listed R.I.D.C. as a secured creditor in the amount of "$420,600.51 plus accrued interest."

The plan of arrangement clearly differentiated between secured and unsecured creditors, specifically adverted to R.I.D.C. as a secured creditor several times and provided for the cancellation, discharge and extinguishment of the indebtedness of "secured creditors," including R.I.D.C. In addition, attached to the plan of arrangement was, as pointed out previously, a document denoted as "Consent of Certain Secured Creditors," which was signed by the president of R.I.D.C. Nowhere in the Plan of Arrangement, the Creditors' Agreement of January 23, 1968, the Acquisition Agreement of January 22, 1968, or the modification thereof of the same date, was there the slightest indication whatsoever that R.I.D.C. had relinquished or waived its security, except as to the debtor's inventory. R.I.D.C. still retained a security interest in the machinery, equipment and tools purchased by SRM from Sunnyhill, although the collateral resided in the hands of SRM.

The plaintiff asserts as significant that the parties to the Acquisition Agreement agreed that SRM would not assume the underlying indebtedness. However, as the defendant correctly points out, the fact that SRM did not assume the debt did not affect the plaintiff's continuing security interest in the property purchased by SRM since the right to foreclose on the security interest was separate and distinct from the right to sue on the underlying obligation. R.I.D.C. could either

sue Sunnyhill on the underlying debt or foreclose its lien on the machinery, equipment and tools which were in the possession of SRM.

The plaintiff contends, however, that it waived its security interest by allowing Sunnyhill to transfer the collateral to SRM subject to the security interest. In effect, the plaintiff contends that a creditor is no longer secured once the debtor is allowed to convey the collateral for the debt to a third party even though the security interest was contractually allowed to survive the transfer. This contention is without merit.

Section 9—105(1) (i) of the Uniform Commercial Code, which is in force in both Florida and Pennsylvania, defines a "secured party" as:

> . . . a lender, seller or other person **in whose favor there is a security interest,** including a person to whom accounts, contract rights or chattel paper have been sold. . . . (emphasis added)

Section 9—105(1) (d) defines a "debtor" as:

> . . . the person who owes payment or other performance of the obligation secured, **whether or not he owns or has rights in the collateral,** and includes the seller of accounts, contract rights or chattel paper. **Where the debtor and the owner of the collateral are not the same person, the term "debtor" means the owner of the collateral in any provision of the Article dealing with the collateral, the obligor, and may include both where the context so**

requires. (emphasis added)

Official Comment 2 to that section states in pertinent part that:

> Occasionally, one person furnishes security for another's debt, and **sometimes property is transferred subject to a secured debt of the transferor which the transferee does not assume;** in such cases, under the second sentence of the definition, the term "debtor" may, depending upon the context, include either or both such persons. . . . (emphasis added)

These pronouncements, taken together, indicate that a secured creditor retains his secured status even though the collateral is transferred to a third party as long as the transfer is subject to the security interest as in this case. Therefore, R.I.D.C. continued to be a secured creditor even though Sunnyhill transferred the collateral for the debt to SMAC pursuant to the acquisition agreement of January 22, 1968.

Thus, this Court holds that R.I.D.C. was a secured creditor at the time the plan of arrangement was confirmed by the bankruptcy court in the Western District of Pennsylvania.

III. THE EFFECT OF THE PLAN OF ARRANGEMENT ON R.I.D.C.

Having concluded that R.I.D.C. was a secured creditor at the time the plan of arrangement was confirmed and that, therefore, the plan of arrangement

would not affect the **statutory** rights under the Bankruptcy Act of R.I.D.C. vis-a-vis the defendant and Sunnyhill despite R.I.D.C.'s voluntary participation in the Chapter XI proceedings, In re Taxes Consumer Finance Corporation, supra, the question then arises as to what was the effect on R.I.D.C.'s legal rights vis-a-vis the defendant apart from those provided for under the Bankruptcy Act.

The defendant contends that the confirmed plan of arrangement, albeit defective insofar as R.I.D.C.'s statutory rights under the Bankruptcy Act are concerned, is nonetheless effective as a contractual composition of creditors. This Court agrees for the reason that the inability of the bankruptcy court to affect R.I.D.C.'s rights as a secured creditor naturally places whatever agreement entered into by the secured creditors with Sunnyhill outside the scope of the bankruptcy law. Without the sanction and control of the bankruptcy court, the practical effect of the defective plan of arrangement as to R.I.D.C. and Sun Capital, as secured creditors, is to leave a naked contractual composition of creditors. Since this is the case, the normal rules of general suretyship law apply so as to release the defendant as a guarantor from liability. 15 Am.Jur.2d, Composition with Creditors, § 7.

This application of the general rule of suretyship law comports with the express language of the plan of arrangement:

> 5. Any indebtedness of unsecured creditors and the secured creditors executing the attached consent remaining unpaid after the

> last of the distributions provided for herein has been made shall be **cancelled, discharged, and extinguished.** Debtors shall so notify such creditors. (emphasis added)

The terms "cancelled" and "extinguished" tend to indicate absolute annihilation of the underlying obligation without any possibility of revival as opposed to the mere "discharge" of the principal debtor which allows for the possibility of restoration or revitalization of the debt under some circumstances and for the continued liability of any sureties.

Therefore, on the basis of the foregoing, this Court concludes that the release of the primary obligor and the extinguishment of the debt under what was a defective plan of arrangement operated to release the defendant guarantor from liability.

IV. CONTRAVENTION OF THE GUARANTY AGREEMENT

As an alternative ground for a decision in favor of the defendant, it should be pointed out that the plaintiff's entry into the plan of arrangement with the primary obligor, without the defendant's written consent, with said plan extending the term of repayment, was in contravention of the terms of the guaranty agreements which provide:

> Guarantors shall not be bound hereunder by any alteration or modification of said Creditors' Agreement, which extends the term of repayment or increases the amount due thereunder without their written approval of

any such alteration or modification.

The lack of written consent by the guarantors as to the plaintiff's participation in the plan of arrangement must be contrasted with the active solicitation and ultimate acquisition of the guarantors' written approval of the acquisition agreement of January 22, 1968, and the Modification of Security Agreement and the Creditors' Agreement of January 23, 1968, which indicates a recognition on the part of plaintiff that such written approval was necessary to prevent the guarantors from being released from liability under the guaranty agreements. Therefore, this Court holds that the plaintiff's entry into the plan of arrangement with the principal debtor without the defendant's written approval, as was required under the terms of the guaranty agreements, operates to release the defendant from liability thereunder. 74 Am.Jur.2d, Suretyship, §§ 50—51.

The fact that the provisions in the plan of arrangement for extension of the time for payment of the debt, to which the defendant did **not** consent, may not have been radically different from the comparable provisions in the Creditors' Agreement of January 23, 1968, to which the defendant **did** consent in writing, as the plaintiff contends, is irrelevant to this holding since the plan of arrangement specifically provided that it "shall supersede the provisions of the Agreement dated January 23, 1968 between the debtor, Sun Capital, R.I.D.C. and the Creditors' Committee. . . ." The written consent executed with respect to the January 1968 Creditors' Agreement cannot be held to have applied with equal effect to the plan of arrangement. Therefore, the plaintiff should

have requested and obtained the defendant's written consent before it attempted to further extend the time for payment of the debt pursuant to the plan of arrangement. Its failure to do so operated to release the defendant.

Therefore, it is

Ordered:

1. A final judgment in favor of the defendant shall be entered contemporaneously herewith by separate document.

2. This order and opinion constitutes this Court's findings of fact and conclusions of law under Rule 52(a) of the Federal Rules of Civil Procedure.

APPENDIX B1

United States Court of Appeals
For The Fifth Circuit

No. 75—1570

D.C. Docket No. CA—72—45
R.I.D.C. INDUSTRIAL
DEVELOPMENT FUND,
Plaintiff—Appellant,
versus
P. L. SNYDER,
Defendant—Appellee.

Appeal from the United States District Court for the
Middle District of Florida
Before WISDOM and MORGAN, Circuit Judges,
and LYNNE, District Judge.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Middle District of Florida, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment

of the said District Court in this cause be, and the same is hereby, reversed and that this cause be and the same is hereby remanded to the said District Court for further proceedings consistent with the opinion of this Court;

It is further ordered that defendant—appellee pay to plaintiff—appellant, the costs on appeal to be taxed by the Clerk of this Court.

September 27, 1976

APPENDIX B2

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF FLORIDA
OCALA DIVISION

R.I.D.C. INDUSTRIAL DEVELOPMENT FUND,

Plaintiff,

v. NO. 72—45—Civ.—Oc

P. L. SNYDER,

Defendant.

FINAL JUDGMENT

This action came on for trial before the Court and the issues having been duly tried and a decision having been duly rendered and findings of fact and conclusions of law having been entered contemporaneously herewith, it is

ORDERED AND ADJUDGED:

That the plaintiff take nothing, that the action be dismissed on the merits, and that the defendant P. L. Snyder recover of the plaintiff R.I.D.C. Industrial

Development Fund his costs of action.

DONE AND ORDERED at Jacksonville, Florida, this 9th day of January, 1975.

/s/ Charles R. Scott
Judge

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 75—1570

R.I.D.C. INDUSTRIAL
DEVELOPMENT FUND,

Plaintiff—Appellant,

versus

P. L. SNYDER,

Defendant—Appellee.

— — — — —

Appeal from the United States District Court for the
Middle District of Florida

— — — — —

ON PETITION FOR REHEARING

(NOVEMBER 8, 1976)

Before WISDOM and MORGAN, Circuit Judges, and LYNNE, District Judge.
PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby denied.

ENTERED FOR THE COURT:

/s/ Louis R. Morgan
United States Circuit Judge

In the Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-844

P. L. SNYDER,

Petitioner,

v.

RIDC INDUSTRIAL DEVELOPMENT FUND,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Of Counsel:

ROBERT LINCOLN POTTER
3900 Forbes Avenue
Pittsburgh, PA. 15260
(412) 624-6228

FRANK D. NEWMAN
P.O. Box 1870
DeLand, Florida 32720

PAUL A. MANION
REED SMITH SHAW & McCLAY
747 Union Trust Building
Pittsburgh, PA. 15219
(412) 288-3236

Counsel for Respondent, RIDC Industrial Development Fund

Financial Press Corporation, Pittsburgh

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COUNTERSTATEMENT OF QUESTIONS PRESENTED

Petitioner has attempted to frame as a single question for review what are in fact two separate but related questions, neither of which presents a substantial federal issue meriting the consideration of this Court:

I. Whether the Fifth Circuit erred in construing the phrase "any indebtedness . . . remaining unpaid . . . shall be cancelled, discharged and distinguished" found in a plan of arrangement confirmed under Chapter XI of the Bankruptcy Act as having the effect of discharging the bankrupt but not a guarantor of the bankrupt?

II. Whether a guarantor of the debt of a bankrupt is discharged from liability to a secured creditor who participates in the debtor's Chapter XI plan of arrangement, notwithstanding that Section 16 of the Bankruptcy Act (11 U.S.C. §34) expressly provides that the guarantor's liability shall not be altered by the discharge of the bankrupt?

ARGUMENT

I. The Fifth Circuit Correctly Construed The Operative Language In The Plan Of Arrangement And That Construction Does Not Involve A Substantial Federal Question.

Petitioner argues that the phrase in the plan of arrangement providing that "[a]ny indebtedness . . . remaining unpaid after the last of the distributions provided for herein has been made shall be cancelled, discharged, and extinguished" must be interpreted to mean that, not only was the Chapter XI debtor in possession discharged (the statutorily-defined effect of the confirmation of a plan of arrangement), but that the debt itself was annihilated and rendered unenforceable with respect to a guarantor whose obligations are explicitly preserved by Section 16 of the Bankruptcy Act.[1] While petitioner did succeed in persuading the district judge to that view (as an alternative holding),[2] the Fifth Circuit (Circuit Judges Wisdom and Morgan and District Judge Lynne) thought that interpretation so meritless and contrary to normal commercial expectations as to warrant rejection in a footnote.[3]

Petitioner asserts that respondent, as appellant in the Fifth Circuit, did not question the correctness of the district court's interpretation of this particular phrase of the plan of arrangement and that petitioner therefore believed "that holding of the District Court to be beyond the scope of appeal." (Cert. Pet. at 4). That assertion is groundless.

---

[1]Section 16 of the Bankruptcy Act, 11 U.S.C §34 (1970), provides:

> "The liability of a person who is a co-debtor with or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of the bankrupt."

[2]387 F. Supp. at 473; Cert. Pet. at 41.

[3]539 F.2d at 490, n. 3; Cert. Pet. at 17.

Respondent's forty-two page principal brief and its eleven page reply brief in the Fifth Circuit made a direct frontal attack on the district court's ruling that petitioner was discharged from his liability as guarantor because of respondent's participation in the plan of arrangement. Inherent and implicit in that attack was respondent's contention that the district court had committed fundamental error in construing the plan of arrangement as discharging petitioner from his liability as guarantor.

Indeed, during oral argument in the Fifth Circuit counsel for petitioner advanced the position, urged here, that the district court's interpretation of the plan of arrangement ("cancelled, discharged and extinguished") constituted a sufficient basis for affirming on appeal, whatever the merit of respondent's other contentions. On rebuttal, counsel for respondent was asked by Circuit Judge Wisdom to speak to this argument. Counsel replied that the interpretation urged was contrary to all reasonable commercial tradition and was merely an inequitable attempt to capitalize on the questionable draftsmanship of a lawyer who, in trying to say the same thing three times, arguably said three different things. The Fifth Circuit obviously agreed with that position.

Petitioner filed a petition for rehearing in the Fifth Circuit in which he again advanced the district court's interpretation of the language in the plan of arrangement as requiring affirmance. The Fifth Circuit denied rehearing summarily. (Cert. Pet. at 49).

Wholly aside from the correctness of the Fifth Circuit's ruling on this point, it is clear that this question—which merely involves the construction of terms found in a plan of arrangement—does not present a substantial federal question and, therefore, does not merit review in this Court.

II. The Fifth Circuit's Decision Is Consistent With Both The Letter And The Spirit Of The Bankruptcy Act.

The Fifth Circuit ruled that the liability of a guarantor is not altered by a secured creditor's participation in the debtor's Chapter XI arrangement proceeding. That ruling is entirely consistent with both the express provisions and the underlying purposes of the Bankruptcy Act.

While it is generally true that a Chapter XI arrangement is a proceeding for the "settlement, satisfaction, or extension . . . of . . . unsecured debts," 11 U.S.C. §706(1), it is equally true that a secured creditor may participate in any bankruptcy proceeding as an unsecured creditor to the extent that his claim exceeds the value of his security. *United States National Bank v. Chase National Bank*, 331 U.S. 28 (1947). In such a case, the discharge in a Chapter XI arrangement of this unsecured indebtedness does not affect the liability of a guarantor of the bankrupt. 11 U.S.C. §34. Indeed, a secured creditor whose claim exceeds the value of his security would prejudice a guarantor, such as petitioner here, by not participating in a Chapter XI arrangement as an unsecured creditor.

Thus, as the Fifth Circuit pointed out in this case,[4] there can be no public policy objections to a secured creditor's participating in a Chapter XI proceeding by surrendering his security to the jurisdiction of the bankruptcy court, permitting the court to value or sell the security, accepting the proceeds in satisfaction of his security interest, and thereafter participating as an unsecured creditor.

Such an option, in fact, makes the Chapter XI procedure a more effective device for all concerned. Where secured creditors (with the indebtedness owed them in default) decline to participate in a Chapter XI arrangement, it is

[4]539 F.2d at 493-94; Cert. Pet. at 23-26.

difficult to secure the necessary consent of unsecured creditors to a plan of arrangement. Should such secured creditors, beyond the statutory power of a Chapter XI bankruptcy court, foreclose or otherwise proceed against the property of the bankrupt which constitutes their security, the ability of the Chapter XI debtor to comply with any plan of arrangement confirmed under that Chapter is doubtful. Unsecured creditors, faced with this uncertainty, will all too often prefer outright liquidation of the debtor where otherwise, had they been able to work with the secured creditors, they might have preferred to let the debtor continue as a going business under Chapter XI. As the Fifth Circuit observed, "it is also to the guarantor's advantage to allow this option since more of the debt will be paid by the debtor."[5]

In summary, the Fifth Circuit's decision on this question:

(1) Is consistent with both the letter and the spirit of the Bankruptcy Act;

(2) Is in conflict with no other decision of any federal court;

(3) Is consistent with an earlier decision of the Fifth Circuit;[6] and

(4) Announces an entirely salutary public policy.

Finally, it should be noted that there are now pending in Congress two bills which would repeal the existing Bankruptcy Act and replace it with a new statute. H.R. 31, 94th Cong., 1st Sess.; H.R. 32, 94th Cong., 1st Sess. Although there is an ongoing legislative debate over the organization and staffing of the bankruptcy courts, both bills would

[5]539 F.2d at 494; Cert. Pet. at 26.

[6]*Armstrong v. Alliance Trust Co.*, 112 F.2d 114 (5th Cir. 1940).

empower a trustee in bankruptcy to assert jurisdiction over secured creditors in arrangement or reorganization proceedings, would empower a trustee or receiver to sell security and distribute the proceeds to the secured creditor, and would thereafter discharge the bankrupt with respect to such secured creditors. Both bills contain a provision, virtually identical to the present Section 16 (11 U.S.C. §34), providing that a discharge of a bankrupt would not affect or alter the liability of guarantors of the bankrupt.

As is well known, prospects for enactment of one or the other of these bills in the near future are good. Hence, this Court, should it grant review, would all too likely be devoting its energies to the interpretation of a statute soon to be repealed.

CONCLUSION

For the foregoing reasons, respondent respectfully submits that the Court should deny the instant petition.

Respectfully submitted,

PAUL A. MANION
REED SMITH SHAW & McCLAY
747 Union Trust Building
Pittsburgh, PA 15219
(412) 288-3236

Of Counsel:

ROBERT LINCOLN POTTER
3900 Forbes Avenue
Pittsburgh, PA 15260
(412) 624-6228

FRANK D. NEWMAN
P.O. Box 1870
DeLand, Florida 32720

CERTIFICATE OF SERVICE

I certify that three copies of the foregoing brief are being served upon counsel for petitioner this 19th day of January, 1977 by air mail, postage prepaid, to the following address:

Robert E. Austin, Jr., Esq.
P.O. Drawer 1357
Leesburg, Florida 32748

/s/ PAUL A. MANION
Counsel for Respondent,
RIDC Industrial Development Fund

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1976

No. 76-844

P.L. SNYDER,

Petitioner,

vs.

R.I.D.C. INDUSTRIAL DEVELOPMENT FUND,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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REPLY BRIEF OF PETITIONER

Robert E. Austin, Jr.
P. O. Drawer 1357
Leesburg, FL 32748
(904) 787-1241
Attorney For Petitioner

Of Counsel:
Timothy A. Burleigh
P. O. Drawer 1357
Leesburg, FL 32748
(904) 787-1241

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REPLY BRIEF OF PETITIONER

ARGUMENT

The Fifth Circuit's Decision is in Conflict with the Decisions of Other Federal Courts.

Respondent, at page 5 of its brief in opposition to the petition for a writ of certiorari, incorrectly states that the decision of the Fifth Circuit "[i]s in conflict

with no other decision of any federal court". In fact, the Fifth Circuit's decision is in conflict with decisions of this Court and of the Second, Fourth, Seventh and Tenth Circuits.

The Fifth Circuit's decision ignores the distinction between discharge of the **debtor** and cancellation, discharge and extinguishment of the **debt**. The effect given language in the plan of arrangement providing for the cancellation, discharge and extinguishment of the debt is the single pivotal issue in a proper determination of petitioner's liability under his guaranty.

The practical effect of the decision of the Fifth Circuit is a determination that discharge of the bankrupt is the same as cancellation, discharge, and extinguishment of the debt. Decisions of this Court and of the Second, Fourth, Seventh and Tenth Circuits demonstrate that the phrases mean entirely different things.

In Zavelo v. Reeves, 227 U.S. 625, 629 (1913), this Court implicitly recognized as follows the distinction between discharge of the debtor and extinguishment of the debt:

> [A] discharge, while releasing the bankrupt from legal liability to pay a debt that was provable in the bankruptcy, leaves him under a moral obligation that is sufficient to support a new promise to pay the debt. . . . The theory is that the discharge destroys the remedy, but not the indebtedness; . . .

The distinction was enunciated more clearly in later cases decided by the Circuit Courts:

> A discharge in bankruptcy does not extinguish a debt but only raises a bar, and the discharge must be pleaded. Beneficial Finance Co. v. Sidwell, 382 F.2d 275, 276 (10th Cir. 1967).

> A discharge is neither a payment nor an extinguishment of a debt. When properly pleaded, it is a bar to the enforcement of an existing debt by legal proceedings and, thus, it amounts merely to a personal defense which is waived if the debtor chooses not to avail himself of it. In re Innis, 140 F.2d 479, 481 (7th Cir. 1944), cert. denied 322 U.S. 736 (1944).

> It must be remembered that a discharge in bankruptcy is neither a payment nor an extinguishment of debts. It is simply a bar to their enforcement by legal proceedings. Helms v. Holmes, 129 F.2d 263, 266 (4th Cir. 1942).

> [T]he discharge provided by Section 17 [of the Bankruptcy Act] does not extinguish debts; it only bars, if pleaded, legal proceedings to enforce payment of the discharged debts. Zwick v. Freemen, 373 F.2d 110, 116 (2d Cir. 1967), cert. denied 389 U.S. 835 (1967).

CONCLUSION

Petitioner does not question the right of a secured creditor to participate in a Chapter XI arrangement. Rather, petitioner urges that once the secured creditor chooses to participate in the arrangement, it should be bound by the plain and unequivocal language of an arrangement in which it joins and to which it consents. A just determination of this cause requires that the construction placed upon the language of the plan of arrangement calling for the cancellation, discharge and extinguishment of the underlying debt be consistent with the decisions of this Court and of the Second, Fourth, Seventh and Tenth Circuits cited in this reply brief.

The petition for a writ of certiorari should be granted.

Respectfully submitted,

Robert E. Austin, Jr.
P. O. Drawer 1357
Leesburg, FL 32748
(904) 787-1241
ATTORNEY FOR PETITIONER

CERTIFICATE OF SERVICE

I CERTIFY that three copies of the foregoing were furnished to each of the following, who are all of the parties required to be served, in compliance with Rule 33.1 of this Court, by air mail, the 26th day of January, 1977:

Frank D. Newman, Esq.
Post Office Box 1870
Deland, FL 32720

Paul A. Manion, Esq.
Messrs. Reed, Smith, Shaw & McClay
747 Union Trust Building
Pittsburg, PA 15219

Robert L. Potter, Esq.
3900 Forbes Avenue
Pittsburg, PA 15260

Robert E. Austin, Jr.